



Testimony of

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Also Supported by

Consumer Federation of America

U.S. Public Interest Research Group

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On the

Check Clearing for the 21st Century Act

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Subcommittee on Financial Institutions and Consumer Credit

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Good morning, Chairman Bachus, Ranking Member Sanders, and Members of the Subcommittee. Thank you for providing me the opportunity to come before you today. I am Janell Mayo Duncan, Legislative and Regulatory Counsel for Consumers Union¹. Consumers Union is the nonprofit publisher of *Consumer Reports* magazine. Our mission at Consumers Union is to test products, inform the public, and protect consumers. Today I offer this testimony on H.R. 1474, the Check Clearing for the 21st Century Act as part of our consumer protection function. My testimony today is supported by the Consumer Federation of America, U.S. Public Interest Research Group, and The National Consumer Law Center.²

If this legislation is enacted into law, it would have a significant impact on an estimated 45 million consumers who receive their original paper checks in the mail every month.³ It would enable banks, thrifts, and credit unions (collectively referred to in this testimony as banks) to convert original paper checks written by consumers into electronic form so they can be sent by banks to other banks that agree to accept them. Consequently, original paper checks would be “truncated,” or stopped by one of the first banks in the system to process a consumer's check. Banks refusing or unable to accept electronic check information would receive a paper

¹ Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide consumers with information, education and counsel about goods, services, health, and personal finance. Consumers Union's income is solely derived from the sale of *Consumer Reports*, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports* with approximately 4.5 million paid circulation, regularly carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions that affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

² Consumer Federation of America is a non-profit association of almost 300 pro-consumer organizations, founded in 1967 to advance the consumer interest.

U.S. Public Interest Research Group (U.S. PIRG) serves as the national lobbying office for state PIRGs, which are non-profit, non-partisan public interest advocacy groups with 400,000 members in states around the country.

The National Consumer Law Center is a nonprofit organization specializing in consumer issues on behalf of low-income people. The Center's experienced attorneys work with thousands of legal services, government and private attorneys, as well as community groups and organizations, from all states who represent low-income and elderly individuals on consumer issues.

³ At an August 2002 meeting, bank representatives stated that approximately 60% of consumers east of the Mississippi River, and 30% of consumers in the West receive their original checks back. Since approximately 90%

"substitute check." During the check return process under the legislation, a check could be repeatedly transferred in and out of electronic and paper substitute form. Thus, the consumer's bank would receive either an electronic image or a "substitute check," but would not receive back the consumer's original paper check. Likewise, the consumer could only get back a "substitute check" but not the original.⁴

Financial institutions already process consumer transactions electronically. In addition, they currently use check imaging technology. However, the full potential impact of this legislation on consumers cannot be forecasted. It will create a new negotiable instrument -- not currently in existence -- called the substitute check. It would authorize a new "dual processing" of checks where a check may be converted in and out of paper form. There will be new benefits and risks associated with this new way of processing consumer checks. The anticipated benefits include costs savings for banks, and possible enhanced banking services for consumers. Potential risks associated with reconvertng check information between paper and electronic form include the double processing of a single check, or errors in reading the amount of or account number on a check -- possibly resulting in losses. The legislation clearly recognizes the possibility that something might go wrong, and provides adequate protections for banks.

I appear before you today to comment on the consumer protection provisions in the legislation. First, we commend the authors of the legislation for including recredit, an easy non-litigation remedy available to consumers to resolve disputes with their banks over funds debited

of the 105 million U.S. households have a bank account, usually a checking account, this means that approximately 45.8 million U.S. households get back their paper checks.

⁴ Today many bank and credit union customers do not receive their checks back in the mail monthly; however, a credit union creates an image of the customer's check at the end of the process, after the check has made its way through the check-clearing process. In contrast, a "substitute check" is a reconstituted version of the consumer's check. Because not all financial institutions will transmit the check in electronic form, the substitute check may contain errors arising during the transmission process. In addition, if the consumer needs the original check due to a claim of improper amount, forgery or alteration (which may require handwriting evidence) the original check will

from their account. However, we believe that recredit should be available to all consumers whose check information is processed electronically -- because they are identically situated relating to potential risks involved in the dual electronic and paper processing of their check information. Second, although consumers that cannot seek recredit from banks are covered by state Uniform Commercial Code (UCC) provisions, and indemnity and warranty provisions in the legislation, these remedies are inadequate because they require a lawsuit to enforce. Third, consumer protections in the legislation should be strengthened because they are weaker than protections that already exist for other forms of consumer transactions conducted electronically. Finally, the comparative negligence provisions should be eliminated or restricted as to consumers because they are broader than under current UCC law, and could give banks an unfair ability to deter, delay, or reduce consumers' claims for damages.

Loophole in Legislation Relating to "Recredit" of Disputed Funds

If the proposed legislation were enacted into law, consumers would need additional protections to address any errors or disputes that occur when their check information is dually processed. In an effort to provide protections, Section 6 of the proposed legislation, among other duties, would require a bank to put up to \$2500 in disputed funds back into a consumer's account if the matter is not settled in 10 business days -- called "recredit."⁵ However, the proposed language would allow consumers to seek recredit of disputed funds only if they receive a "substitute check" from their bank.

now be in the custody of someone other than the consumer's own bank, and so it would take longer to find and retrieve.

⁵ We believe that this amount should not be limited to \$2500. Recredit amounts are not limited for consumers who conduct electronic transfers. In addition, although the majority of consumer checks written are below this amount, improper debits may be in excess of the average consumer check amount -- for example, the improper placement of a decimal point that could raise an incorrect debit by a factor of 10.

This is a significant loophole because a bank could avoid giving account-holders these rights simply by refusing to return substitute checks to them. Nothing in the bill requires the bank to provide consumers with a substitute check. If a bank does not give a substitute check to its account-holder, the customer loses the right to recredit, and is left with weaker UCC remedies found under state law (UCC Articles 3 and 4) which govern negotiable instruments, including checks.⁶ UCC liability provisions are not comparable to recredit because, although they provide rules for liability, they lack a non-litigation remedy. In addition, UCC provisions do not set a specific time period to resolve disputes, and do not require a bank to redeposit disputed funds. If a bank delays or declines to solve the problem, the only way for the consumer to get his or her money back under the UCC is to sue, which is too expensive and time consuming for most disputes relating to modest amounts.

The warranty and indemnity provisions in Sections 4 and 5 of the legislation establish responsibilities and liabilities for banks that improperly create or process substitute checks -- leading to harm. However, in order to obtain a remedy for losses due to an improperly processed check under the warranty and indemnity provisions, consumers (as well as banks) would be forced to sue. While these indemnity and warranty provisions in the legislation may be appropriate as they relate to disputes between banks, they are inappropriate for a consumer dispute with a bank because of unequal bargaining power, and because they require a lawsuit to enforce. As discussed earlier, this is an expensive and cost-prohibitive prospect for most amounts likely to be in dispute. We therefore believe that the non-litigation recredit provision is appropriate because during any delay in resolving a dispute, consumers could be denied access to

⁶ Presumably, a substitute check also will be governed by the UCC. The legislation states that it "shall be the legal equivalent of the original check for all purposes, including any provision of any Federal or State law, and for all persons" See Section 3(b). However, under the legislation, the UCC shall apply only to the extent that it is not "inconsistent with this Act. " See Section 12, "Effect on Other Law."

rightful and necessary funds. Recredit properly places the burden of delay on the bank rather than the consumer, and should be extended to all consumers, regardless of whether or not he or she receives a "substitute check." This would be a modest change to the bill that would improve it significantly.

Anti-Fraud Protections in Legislation are Broad, Discretionary, and More than Adequate

One argument made against extending the recredit protections to all consumers involves concerns that broad availability of the recredit protections increases the exposure of banks to fraudulent claims. The legislation contains strong anti-fraud provisions that should minimize, if not eliminate concerns banks have if the recredit provisions are made available to all consumers. The legislation grants banks broad discretion to delay a consumer's recredit, and even reverse recredit (without notice) where it has been granted unnecessarily. Under the anti-fraud provisions, a bank may delay recredit of funds until it confirms the claim is valid (or 45 days after a claim is submitted) for 1) new accounts; 2) accounts with repeated overdrafts; or 3) when the bank has a reasonable basis to believe the claim is fraudulent.⁷ Further, even if the bank has already recredited consumer funds, it can remove them -- without prior notice -- if it concludes that a recredit was made for properly debited amounts.⁸ We believe that these provisions provide more than adequate fraud protections for banks. As such, concerns that may be expressed about potential fraud do not provide a credible reason to deny the consumer recredit protections to an entire class of consumers -- those who do not receive a substitute check.

⁷ See Section 6(d)(2).

⁸ See Section 6(e).

Protections Afforded to Consumers in Legislation are Weaker Than Those Afforded for Other Types of Electronic Consumer Transactions

Currently, consumers engaging in other electronic funds transfers (e.g. using debit or ATM cards or allowing funds to be debited directly from their accounts) are protected by Regulation E,⁹ which includes a 10 day right of recredit, and has no dollar limit. Although the proposed legislation would allow all banks to turn consumer paper check processing into electronic transmissions of check information, the recredit section fails to give consumers protections equivalent to those governing other types of electronic funds transfers. Again, the protections in the legislation are inadequate because they do not apply to all consumers. In addition, the risks associated with the substitute check may be greater than those in purely electronic transactions, because the substitute check system may be complicated by the potential multiple conversion of consumer check images and information in and out of paper form. We see no justification for having protections in this legislation that are weaker, than those in Regulation E.

Comparative Negligence Provisions Grants Banks Greater Defenses Than Current Law

⁹ 12 C.F.R. Part 205.

The proposed legislation contains provisions that would make it harder for consumers to seek damages from banks for improperly paid checks.¹⁰ These comparative negligence standards in Sections 5(c) and 9(b) of the proposed legislation would allow banks to reduce the amount of damages a consumer can recover by asserting that the consumer was somehow at fault (*i.e.*, comparatively negligent). Despite the creation of this defense, it is highly unlikely that a consumer could actually contribute in any way to the double processing of his or her checks, or to a processing error. This provision would unfairly enable a bank to deter a consumer's claim, or make any litigation longer and more expensive by asserting that the consumer was somehow partly responsible for check processing errors.

The legislation's comparative negligence provisions are much broader than those currently governing consumer check transactions under the UCC. Although the UCC imposes a comparative negligence standard, it does so only relating to fraud.¹¹ The legislation therefore would give banks greater protections than exist under current law by extending a bank's ability to claim a defense of comparative negligence beyond situations where there has been a loss to the consumer due to fraud or forgery. This expansion would make it harder for consumers to collect judgments against banks responsible for processing errors. We therefore believe that the comparative negligence standards in Sections 5(c) and 9(b) of the proposed legislation are inappropriate to resolve harms suffered by consumers due to processing errors, and should be removed.

¹⁰ Under Section 9(b) of the legislation, a bank could raise a comparative negligence defense with respect to every claim by a consumer that his or her account had been improperly debited (*i.e.*, a "warranty claim"). See Section 9(b). Similarly, the legislation also would allow banks to raise a comparative negligence defense if a consumer seeks indemnity for harm caused by the unavailability of the original check. See Section 5(c).

¹¹ The first instance relates to fictitious payees or imposters [3-404(d)], the second involves where a consumer's negligence contributes to a loss due to a forged signature or alteration [3-406(c)]. Finally, under the UCC, an account-holder has a duty to be diligent in reviewing his or her monthly statement, and report any item paid that was improperly altered or contains an unauthorized signature. If the consumer fails to examine his or her statement and

Recommendations

We recommend the following changes to the legislation to more properly balance the benefit of increased check processing efficiencies with necessary consumer protections:

1. Because all consumers are identically situated relating to potential risks involved in the dual electronic and paper processing of their check information, the recredit loophole in the legislation should be closed. The right of recredit should therefore be expanded to all consumers in every case where a check may have been improperly charged to a consumer's account; and
2. A comparative negligence standard is inappropriate to resolve harms suffered by consumers due to processing errors. Banks should not be able to use this standard to avoid liability, or to delay a consumer's action for improperly paid checks that result from processing errors. Therefore, as it relates to consumers, the language relating to a comparative negligence standard should be removed from the proposed legislation.

We believe that these two elements are the most important changes to be made to the bill in order to create more balanced legislation.

I thank the Chairman, Ranking Member Sanders, and the Subcommittee for the opportunity to testify, and I look forward your questions.

discover and report such indications of fraud, then he or she may lose the ability to assert a claim against the bank for wrongful payment [4-406].